United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-5021

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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In the Matter

of

FLYING MAILMEN SERVICE, INC.,

Bankrupt

----------x

Docket No.75-5021

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P/S

CHARLES GOLD,

Plaintiff-Appellant,

v.

HERBERT K. LIPPMAN, Trustee in Bankruptcy of Flying Mailmen Service, Inc.

Defendant-Appellee.

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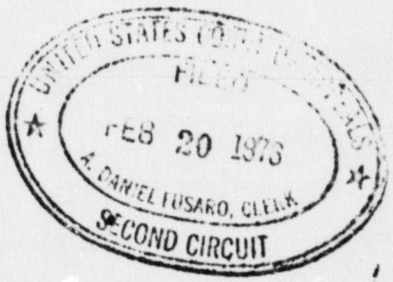

BRIEF FOR APPELLANT

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BRIEF FOR APPELLANT

This is an appeal from an order by Judge Lasker in a bankruptcy proceeding. His opinion is reported in 402 F. Supp. 790. The order appealed from affirmed an order by Bankruptcy Judge Herzog to the extent that it denied appellant's right to be a secured creditor with respect to so much of his claim as arose from the purchase of its own stock by the corporation which became bankrupt. It remanded the

case to the Bankruptcy Court to determine the date when the corporation became insolvent so as to decide what, if any, of the moneys received by appellant might have to be returned. The order also remanded to give the Trustee an opportunity to move to amend his answer to challenge the validity of the basic agreement.

THE ISSUES

1. The District Court erred in denying appellant status as a secured creditor for the full unpaid balance of his claim.

2. In the event this Court does not agree with our first contention, the question remains whether the District Court adequately indicated the proper allocation of the payments between appellant's claims not related to the sale of his stock and his claim based on the sale of the stock.

STATEMENT OF THE CASE

Appellant was a stockholder of the later bankrupt, Flying Mailmen Service, Inc. (A. 2). In 1970 he had sued the corporation and others in the New York Supreme Court, in which case a temporary receiver of the corporation had been appointed (A. 1, 2). On December 16, 1970, while an

appeal was pending from that order, an agreement of settlement was entered into (A. 6). That provided for the payment of $150,000, of which 17% was for claims asserted by appellant and 83% for the purchase of his stock (A. 10). $57,500 was paid down, the balance to be paid in bi-monthly installments of $5,138.88, commencing March 1, 1971 (A.10). The agreement gave appellant a security interest in certain assets of the corporation for the installments to be paid (A12,13). Early in January 1971 appellant perfected the security interest by filing a financing statement pursuant to New York's Uniform Commercial Code, §9-402 (A. 2, 3).

That statement contained, among other things, the following: "This Financing Statement has been executed pursuant to an agreement dated December 16, 1970 between Charles Gold, the Secured Party, and * * * Flying Mailmen Service, Inc. * * * ." (A. 36).

Thereafter, installments were paid aggregating $25,500 (A. 3) before the corporation filed a Chapter XI proceeding in January 1972 (A. 3). During the pendency of that proceeding two installments were paid appellant in escrow, with interest to their due dates, totaling $11,200 (A. 4). Subsequently the corporation was declared a bankrupt (A. 3).

Appellant then asked the Bankruptcy Court to enforce the security given by the agreement and declare him a secured creditor (A. 3). That application was denied by Judge Herzog, who also directed appellant to return the $11,200 he had received after the filing (A. 4).

In the proceedings before the Bankruptcy Court the Trustee sought to challenge the agreement of December 1970 as unconscionable, but Judge Herzog refused to permit this (A. 4).

On Appellant's appeal to the District Court, Judge Lasker upheld the Bankruptcy Court's denial of appellant's claim to be a secured creditor (A. 4). He did not uphold the order to return the moneys paid after the Chapter XI filing, but ordered a remand to determine the date on which the corporation became insolvent so that an allocation of the moneys received could be made between appellant's claims unrelated to the stock purchase and the stock purchase (A. 4). He also, on the remand, gave the Trustee the right to move to amend his answer (A. 4). As already noted, his opinion has been reported and the references to it hereafter will be both to Appellant's Appendix and the Federal Supplement.

The refusal to allow appellant's claim to be a secured creditor for the unpaid balance of the purchase price of his stock rested on New York Business Corporation Law §513(a) and §514(a). These statutes permit a corporation to

purchase its own stock only out of surplus, and this is interpreted to mean that there must be such surplus at the time payments are made.

The District Court also rejected appellant's claim that the filing of the financing statement barred creditors from raising this contention on the ground that the statement did not specifically refer to the fact that part of the consideration arose from the purchase of its own stock by the corporation. In so ruling both courts ignored the fact that the financing statement did specifically refer by date to the agreement of December 1970. (See our Point I.)

POINT I

THE DISTRICT COURT ERRED IN DENYING APPELLANT STATUS AS A SECURED CREDITOR FOR THE FULL UNPAID BALANCE OF HIS CLAIM.

As already noted, the corporation which later became bankrupt agreed to pay appellant $150,000, partly in settlement of claims, partly for the purchase of his stock. The agreement gave appellant a secured interest in certain assets of the corporation (A. 2). To perfect that interest appellant filed a financing statement under New York Uniform Commercial Code §9-402 (quoted hereafter)(A. 2). That statement specifically referred to the underlying agreement by date (A.3).

At the time the corporation filed in Chapter XI, $83,000 had been paid, leaving $67,000 still due (A. 3). For that amount appellant petitioned to be declared a secured creditor.

Both the Bankruptcy Court and the District Court rejected the claim on the ground that payment for the stock after the corporation became insolvent violated New York Business Corporation Law §513(a) and §514(a). In reaching that conclusion the Bankruptcy Court, but not the District Court, considered the entire unpaid balance as part of the purchase price of the stock.

Appellant countered with the contention that the filing of the financing statement put creditors on notice so that they were barred from claiming any violation of the Business Corporation Law. That doctrine was expounded in Cross v. Beguelin, 252 N.Y. 262 (1969).

In that case the Court said at page 266: "The rights of the seller of the stock appear to be superior to those of the subsequent creditors of the corporation who became such with notice of the purchase by the corporation of its own stock," citing First Trust Co. v. Ill. Cent. R. Co., 256 Fed. Rep. 830 (1919). In the Cross case the notice was actual, by participation as directors in the resolution to buy the stock. No question of the sufficiency of a filed

instrument was there involved.

Both the Bankruptcy Court and the District Court recognized the existence of the rule announced in Cross but held it inapplicable on the ground that appellant's financing statement did not disclose that part of the transaction was for the purchase of the corporation's stock. Appellant contends the New York statute does not require that this be done and that since the statement referred by date to the underlying security agreement, creditors were put on inquiry and should be barred.

Judge Lasker, in rejecting that contention in effect rewrote the statute, which a court may not do. He noted that the case was "one of first impression" (A. 64); 402 F. Supp. 790, at 793) and that no earlier case had ruled that a financing statement had to specify the nature of the consideration (A. 67; id. at 794). He, however, gave a misleading impression when he said (A. 67; id. at 794) that the only notices which had been held to limit creditors' rights did contain information that a corporation's purchase of its own stock was involved.

Actually, there was only one such case, First Trust Co., supra. And that did not involve a financing statement, but a mortgage. Such mortgage necessarily stated the nature

of the consideration, being, in effect, the security agreement between the parties, which, under present New York law, need not be filed [Bank of Utica v. South Rich eld Springs,Inc., 58 Misc.2d 113, 114 (1968)]. So there is, in fact, no basis for the inference Judge Lasker sought to draw. And he completely ignored the fact that in the case at bar the statement referred by date to the underlying agreement, inspection of which would have informed any creditor that the obligation arose in part from the purchase of the corporation's stock.

We submit that the cases relied upon by Judge Lasker do not sustain his conclusion and that the requirements of the New York law as to filing have been fully complied with.

The statute in force at the time of the filing in January 1971 [§9-402(1), as amended effective July 1, 1970] says:

> "A financing statement is sufficient if it is signed by the debtor and the secured party, gives an address of the secured party from which information concerning the secured interest may be obtained, gives a mailing address of the debtor and contains a statement indicating the types, or describing the items, of collateral. * * *"

The statement here filed (A. 36) complied in every respect with this requirement. It stated that the security arose under the agreement of December 1970.

It should be noted that the statute does not require either the filing of the security agreement [which had formerly been required (see Bank of Utica v. South Richfield Springs, Inc., supra)] nor that the statement specify the nature of the obligation for which the security was given.

The only New York appellate decisions that deal with the sufficiency of a financing statement that we have found are Beneficial Finance Co. of New York, Inc. v. Kurland Cadillac-Oldsmobile, Inc., 32 A.D.2d 643 (2d Dept. 1969), and John Deere Company of Baltimore, Inc. v. William C. Pahl Construction Co., Inc., 34 A.D.2d 85 (9th Dept. 1970), affirming 59 Misc.2d 872.

In the first case the statement was held sufficient despite the failure of the creditor to mark a box on the form indicating that debtor had signed a security agreement. The Court said at page 645:

> " * * * In reaching the conclusion that the financing statement was effective, we implement the policy of the code that the law governing commercial transactions be simplified and modernized, and liberally construed to achieve that objective * * *. The purpose of a notice-filing statute is to give protection to a creditor by furnishing to others intending to enter into a transaction with the debtor a starting point for investigation which will result in fair warning concerning the transaction contemplated (Rooney v. Mason, 394 F.2d 250; Strevell-Paterson Finance Co. v. May, 77 N.M. 331; Plemens v. Didde-

Glaser, 244 Md. 556; Alloway v. Stuart, 385 S.W.2d 41 [Ky.]; 1 Gilmore, Security Interests in Personal Property, pp. 468-470). * * *"

In the second case the Court found the statement insufficient because the name of the debtor was misspelled, a situation that does not exist here.*

Lower courts have also interpreted the statute liberally.

In Bank of Utica v. South Richfield Springs, Inc., supra, the Court held that a statement covered after-acquired property of the kind described and that it did not have to so state. The Court said at page 114:

"The purpose of filing is to put the public generally on notice of a prior interest in collateral so that the inquiry can be made."
(emphasis ours)

To like effect is Sunshine v. Sanray Floor Covering Corp., 64 Misc.2d 780 (1970).

In Matter of Marta Coop., 74 Misc.2d 612 (1973), the Court said at page 613:

"The function of a financing statement is to

*There was evidence in that case that a search had been made against the correct name of the debtor and several financing statements found, but not the one in dispute. There is no evidence in our case that any creditor made a search against the corporation.

notify subsequent creditors that a security interest may exist. * * * The financing statement is not intended then to embody the agreement between the parties. * * *" (emphasis in the original)

Finally, there is Marine Midland Bank-Eastern National Association v. Conerty Pontiac-Buick, Inc., 77 Misc.2d 311 (1974), where the Court said at page 314:

" * * * The financing statement is designed merely to put creditors on notice that further inquiry is prudent."

New York law was considered in Bank of North America v. Bank of Nutley, 94 N.J. Super. 220, 227 A.2d 535 (1967). There the Court said (227 A.2d at 539):

"The section contemplates that the complete state of affairs will be learned only after such inquiry."

The function of a financing statement was also considered in the recent case of In re Gilchrist Company, 403 F. Supp. 197 (1975) (Advance Sheet, Jan. 12, 1976). There the Bankruptcy Court, whose decision was affirmed by the District Court, said at page 201:

" * * * Any party searching the records as to the possible existence of a security interest in Gilchrist's accounts receivable would have found the original financing statements and the continuation statements. This would be enough to cause inquiry to be made from the Bank to determine the

> status of any loan. This is the very purpose of the 'notice filing' required by Section 9-402(1) of the Uniform Commercial Code ("Code"). In Official Comment 2 to Section 9-402, the draftsmen noted that the security agreement itself need not be filed, but a mere notice indicating 'merely that the secured party who has filed may have a security interest in the collateral described. Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs ***'"
>
> (emphasis in the original)

The law thus seems to be clear that the function of the financing statement is merely to put a person intending to become a creditor on notice that someone claims to have a secured interest in certain property. Nowhere is there a suggestion that the statement should indicate how the secured interest arose. It is supposed that an alert intending creditor will ask to look at the security agreement to find that out. We submit, therefore, that there is no justification for the District Court's having imposed the requirement that it did.

Judge Lasker cited only three cases which dealt with the effect of a recorded instrument: First Trust Co. v. Illinois Central R. Co., 256 F. 830 (8th Cir. 1919); In re Bay Ridge Inn, Inc., 98 F.2d 85 (2d Cir. 1938), and In re Dawson Brothers Construction Co., 218 F. Supp.411 (N.D.N.Y. 1963).

Not one of these dealt with a financing statement.

In the first case a mortgage recited that it was given for the purchase of the corporation's own stock and subsequent creditors were held barred.

In the second case a chattel mortgage was issued by a corporation to secure the purchase price of its stock at a time when it had no surplus. The mortgage falsely recited that it was given to secure loans by the stockholders. That was held to have misled anyone examining the record. Here there was no false statement of any kind.

In the last case the stockholders relied on the fact that the corporation had filed papers showing a reduction in its capital. But since the filed document gave no notice of any obligations created in favor of the stockholders, the Court held it irrelevant.

Since none of these cases dealt with the effect of a financing statement under New York's liberal statute which was strictly complied with here, we cannot see how they have any relevance here.

Finally, Judge Lasker adverted to the general rule that federal law governs the relative priorities of claims, citing In re Bell Tone Records, 86 F. Supp. 806 (D.N.J. 1949). However, the warning noted by the Supreme Court in Prudence

Corp. v. Geist, 316 U. S. 89, 95 (1942), that there be "appropriate regard for rights acquired under rules of state law" must be kept in mind and should be applied here.

In the recent case of Matter of Federal's, Inc., 402 F. Supp. 1357 (E.D. Mich. 1975) (Advance Sheet, Jan. 12, 1976), Judge Freeman treated the problem of priorities posed by Section 64 of the Act as applicable only to unsecured creditors. (Footnote 8 on page 1368).

See also In Re Gilchrist Company, supra. There (p. 200) the Court held that security given followed by the recording of a financial statement gave the creditor a preferred position in bankruptcy.

The First Circuit has laid down the same rule in In re Cushman's Bakery, 526 F. 2d 23 (1975) (Advance Sheet Feb. 2, 1976). At page 30, Judge Coffin said:

> "Whether a security interest has been perfected against the trustee in bankruptcy is exclusively a question of state law."

And the Court there held that the financing statement need not disclose the nature of the transaction (See pp. 28, 29).

Actually, we are not concerned here with relative priorities but with the question whether, under New York law, appellant obtained a valid secured interest. If, as we believe we have shown, that is so, then it cannot be ignored by the bankruptcy court as these recent cases hold.

POINT II

IN THE EVENT THIS COURT DOES NOT AGREE WITH OUR FIRST CONTENTION, THE QUESTION REMAINS WHETHER THE DISTRICT COURT ADEQUATELY INDICATED THE PROPER ALLOCATION OF THE PAYMENTS BETWEEN APPELLANT'S CLAIMS NOT RELATED TO THE SALE OF HIS STOCK AND HIS CLAIM BASED ON THE SALE OF THE STOCK.

As we have already mentioned, the underlying agreement provided that 17% of the $150,000, or $25,500, should be for appellant's claims and 83%, or $124,500, for his stock (A. 2). At the time of the filing, $83,000 had been paid (A. 3).

The Bankruptcy Court ruled that the payments absorbed the $25,500 (A. 69). It rested its conclusion on two grounds: that the agreement specified how the moneys were to be allocated; that payments made by a corporation without a surplus must be credited to claims other than the purchase of the stock. (This second ground proceeded on an unproved assumption that there was no surplus through the period of the payments.)

Judge Lasker's statement (A. 69 ; 402 F. Supp. 795) that he agreed with the Bankruptcy Court's "disposition" is confusing because he obviously did not affirm the Court's direction that appellant return the moneys received after the Chapter XI filing. For had he done so there would have been no need for a remand to determine the date of insolvency. He

noted how the contract allocated the payments and said: "It is reasonable to conclude that each installment was to be allocated similarly" (A. 70; 402 F. Supp. at 795).

On that theory, with which we agree, the $83,000 paid before the Chapter XI proceeding was instituted should have been apportioned $14,110 to appellant's claims, and $68,890 to the stock. If the corporation remained solvent until the Chapter XI filing, then appellant should be declared a secured creditor to the extent of $11,390, and the $10,376* received by him after the filing should be applied to that claim and not have to be repaid by him, leaving an additional $1,014 to which appellant would be entitled, with interest.

On the other hand, if it be found that the corporation was insolvent at some time prior to the Chapter XI filing, some of the moneys attributed to the purchase of the stock under the agreement might have to be applied against this $11,390 balance.

While Judge Lasker did not spell this out, that is probably what he meant by his statement about a different allocation (A. 70; id. at 796). Therefore, if our main

*We have used this figure, being two installments as fixed in the contract, rather than the $11,200 actually received by appellant since that figure included interest.

contention be not accepted, we agree that there has to be a remand to determine the date of insolvency and make the proper allocation under the agreement.

CONCLUSION

We submit that the District Court erred in denying appellant status as a secured creditor and that he should be declared to be such for the full amount of his unpaid claim, with interest from the respective dates on which the unpaid installments were due. At the time of the filing of the Chapter XI proceeding, that unpaid balance was approximately $67,000.

If, however, this Court rejects our basic contention so that the date of insolvency becomes material, then, on remand, there must be an allocation as provided in the basic agreement. If there was no insolvency prior to the filing of the Chapter XI proceeding, then appellant is entitled to keep the moneys received after that filing and he has a secured claim for $1,014 with interest in addition.

Respectfully submitted,

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Service of three ③ copies of the within
is admitted this 26th day of January 1976

Attorney for Respondent Appellee
by Carl Cannata